

Graham S. Steele

Staff Director, Corporations and Society Initiative
Stanford Graduate School of Business

June 21, 2019

Ann E. Misback

Secretary

Board of Governors of the Federal Reserve System

20th Street and Constitution Avenue, N.W.

Washington, D.C. 20551

Docket No. R-1658;

RIN 7100–AF45

Re: Prudential Standards for Large Foreign Banking Organizations; Revisions to Proposed Prudential Standards for Large Domestic Bank Holding Companies and Savings and Loan Holding Companies

Ladies and Gentlemen:

I write today to comment on the Board's proposed framework for Foreign Banking Organizations (FBOs). I oppose most aspects of the proposed rule for the four reasons described below. Further, I support the changes to FBO reporting and believe that they should be accompanied by more comprehensive regulation of all of the U.S. operations of FBOs.

I. The Proposed Rules are contrary to the stated intent of the sponsors of S. 2155.

The proposed FBO rule runs contrary to the legislative history of the laws cited as the source of its authority, section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act as amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act.¹

¹ See 84 Fed. Reg. 21,988, 21,990 ("The proposal is the result of this practice, and reflects amendments to section 165 of the Dodd-Frank Act under the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)."); *see id.*, at 21,992 ("Consistent with the domestic proposal and EGRRCPA's amendments to section 165 of the Dodd-Frank Act, this proposal generally would increase the asset size threshold for application of the enhanced prudential standards framework to foreign banking organizations[.]"). The proposal also cites consistency with "principles of national treatment and equality of competitive opportunity between foreign and domestic banking organizations." *Id.* However, the Board has significant discretion to apply that principle. See Governor Daniel K. Tarullo, "Regulation of Foreign Banking Organizations," Nov. 28, 2012, at 2, n.2 ("Of course, differences in business organization, domestic regulatory systems, and other factors mean that there must sometimes be determinations whether foreign and domestic firms are 'like' one another in relevant respects.").

When asked by one of the bill's sponsors whether S. 2155 "require[s] the Federal Reserve to weaken any of the Dodd-Frank enhanced prudential standards for the FBO such as Deutsche Bank, UBS, or Barclays," Chairman Powell replied: "It does not[.]"² Chairman Powell further agreed that the rules applicable to Intermediate Holding Companies (IHCs) of FBOs were not required by the Dodd-Frank Act, and that the legislation, S. 2155, "does not require any change to the IHC [regime]."³

Indeed, other sponsors of the legislation called the suggestion that it would weaken oversight of the largest foreign banks a "boogeyman" and said that it was important to clarify this intent "when a court is reviewing this provision—if, in fact, there is ever litigation[.]"⁴ Given the statements of the legislation's sponsors, the Board should reconsider its proposal on the grounds that it is contrary to legislative intent, as well as the Board's own interpretation.

II. The Proposed Rule Understates the Potential Threats to Financial Stability Posed by Foreign Banks.

During the financial crisis, the Federal Reserve system provided \$538 billion in emergency loans to the U.S. units of European banks, almost as much as the assistance it provided to U.S. firms.⁵ True to this experience, these firms present unique and heightened risks because they tend to have more volatile asset compositions,⁶ and they are not as well capitalized as U.S. banks.⁷

Six large FBOs have systemic risk scores that are comparable to the largest U.S. GSIBs,⁸ and yet the proposal would subject them to less stringent requirements than the U.S. GSIBs. This is especially troubling because systemic risk scores omit additional factors that should be taken into account for banks headquartered in foreign countries. For example, the extent to which a bank's home sovereign relies on the bank for funding activities and financial services can

² See The Semiannual Monetary Policy Report to the Congress, Committee on Banking, Housing, and Urban Affairs, United States Senate, S. Hrg. 115–242, at 12 (2018) available at: <https://www.govinfo.gov/content/pkg/CHRG-115shrg30197/pdf/CHRG-115shrg30197.pdf>.

³ *Id.*, at 13.

⁴ Cong. Rec. S1659 (Mar. 13, 2018), available at: <https://www.congress.gov/115/crec/2018/03/13/CREC-2018-03-13-pt1-PgS1656-2.pdf>.

⁵ See Yalman Onaran & Bradley Keoun, *U.S. Said to Weigh Tightening Rules for Foreign Lenders*, Bloomberg, Nov. 28, 2012.

⁶ See Daniel E. Nolle, *Foreign-Owned Banks: (Way) Underestimated — and Volatile — Participants in the U.S. Banking Market*, 1 J. of Fin. Perspectives 1 (2013).

⁷ See FDIC, Global Capital Index, Dec. 2017 (finding that U.S. GSIBs have a weighted average leverage ratio of 6.92% under IFRS, while European GSIBs have a weighted average leverage ratio of 4.81% under IFRS) available at: <https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio4q17.pdf>; see also Justin Baer & Max Colchester, *U.S. Banks Take Global Lead*, Wall St. J., July 30, 2015; see also Martin Arnold, *How U.S. Banks Took Over the Financial World*, Fin. Times, Sept. 16, 2018 (citing the statistic the JPMorgan's market capitalization of \$380 billion exceeds that of RBS, HSBC, BNP Paribas, Barclays, and Deutsche Bank, combined).

⁸ See Paul Glasserman & Bert Loudis, *A Comparison of U.S. and International Global Systemically Important Banks 2*, Figure 1, Office of Financial Research Brief 15-07 (2015): <https://www.financialresearch.gov/briefs/files/OFRBr-2015-07-A-Comparison-of-US-and-International-Global-Systemically-Important-Banks.pdf>

contribute to a bank's systemic importance.⁹ We know that some countries had to bail out their banks,¹⁰ but this proposition also becomes more challenging when the assets of such banks exceed the GDP of their home country. In such a scenario, the U.S. may be forced to either deal with the costs from the failure of an FBO or provide the bailout of last resort. Omitting these considerations understates their unique risks to the U.S. financial system.

Finally, FBOs are a greater source of risk than their U.S. counterparts and the rules should treat them as such. As Governor Tarullo has observed “while internationally active banks live globally, they may well die locally.”¹¹ As the crisis demonstrated, a bank that has large foreign assets and large intrafinancial system liabilities is a potential source of spillover risk.¹² Conversely, the evidence suggests that crises and their aftermath cause international banks to retrench to their home countries.¹³ In the case of the U.S. market, that would mean a potential contraction of up to 20 percent of the domestic banking industry.¹⁴

III. Large Foreign Banks' Demonstrated Governance and Management Failings Make Them Unworthy of Deregulation.

If deregulation is ever appropriate, it should only be enjoyed by the best actors, the banks that have exhibited exemplary behavior and management practices. Unfortunately, it is difficult to overstate the litany of problems – from basic risk management and governance failures to purposefully illegal behavior – that some FBOs have exhibited over the past decade and a half.

For example, the German giant Deutsche Bank has been:

⁹ See Meraj Allahrakha, Paul Glasserman & H. Peyton Young, Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data 7, Office of Financial Research Brief 15-01 (2015), available at <https://www.financialresearch.gov/briefs/files/2015-02-12-systemic-importance-indicators-for-us-bank-holding-companies.pdf>.

¹⁰ For example, UBS received about \$60 billion from the Swiss central bank and RBS received about \$74 billion from the U.K. government.

¹¹ Tarullo, “Regulation of Foreign Banking Organizations,” *supra*, at 10.

¹² See Allahrakha, Glasserman & Young, *supra*, at 6.

¹³ See, e.g., Lorenz Emter, Martin Schmitz & Marcel Tirpák, Cross-Border Banking in the EU Since the Crisis: What is Driving the Great Retrenchment?, European Central Bank Working Paper No. 2130 (Feb. 2018); see also Arnold, *How U.S. Banks Took Over the Financial World*, *supra* (quoting a corporate treasurer in the U.K. saying that “In the last crisis everybody took their ball home and retrenched to their domestic market”).

¹⁴ See Noelle, *Foreign-Owned Banks*, 1 J. of Fin. Perspectives, at 4 (statistic includes all foreign-owned banks in the U.S., including branches and agencies and subsidiary commercial banks).

- So poorly capitalized during and after the financial crisis that its U.S. holding company had a negative capital ratio,¹⁵ and the mere mention of a fine related to its role in the financial crisis led to questions about its solvency;¹⁶
- Accused by U.S. and U.K. regulators of rigging the LIBOR benchmark rate;¹⁷
- Accused by federal and state authorities of repeatedly violating U.S. sanctions from sanctions violations from 1999 to 2006 for handling transactions involving Iran, Libya, Syria, Myanmar, and Sudan;¹⁸
- Fined by U.S. regulators for its involvement in facilitating laundering over \$10 billion out of Russia in evasion of sanctions in the “mirror trades” scandal;¹⁹
- Subject to a variety of supervisory actions for deficient risk controls and reporting problems;²⁰ and
- Made to pay out a total of more than \$18 billion in fines and legal settlements over the past decade.²¹

These issues are not things of the past. Deutsche is reportedly planning to create a “bad bank” to house some of its most complex and opaque derivatives investments,²² there are also reports that the Board is planning to take additional supervisory action against the bank,²³ and it is reportedly the subject of yet another money laundering investigation.²⁴

In another example, the Spanish bank Santander was:

¹⁵ See Tom Braithwaite & Shahien Nasiripour, *Deutsche Bank Avoids U.S. Capital Rules*, Fin. Times, Mar. 21, 2012 (“Deutsche’s US bank holding company, named Taunus after a German mountain range, has drawn particular ire from the Federal Deposit Insurance Corp for maintaining a negative capital ratio. As of the end of last year, according to official data, Taunus had a ratio of tier one common equity capital to risk-weighted assets of -6.1 per cent.”).

¹⁶ See Jan Strupczewski, *U.S. Fine on Deutsche Bank Too Big, Damaging to Stability: Dijsselbloem*, Reuters, Oct. 7, 2016.

¹⁷ See Nicholas Comfort, *Deutsche Bank’s Legal Troubles Just Don’t Seem to End: Timeline*, Bloomberg, Nov. 29, 2018.

¹⁸ See *id.*

¹⁹ See *id.*

²⁰ See David Enrich, Jenny Strasburg & Eyk Henning, *Deutsche Bank Suffers From Litany of Reporting Problems, Regulators Said*, Wall St. J., July 22, 2014; see also Jenny Strasburg, Scott Patterson & David Enrich, *Deutsche Bank Ordered by U.S. Regulators to Improve Reporting Systems, Risk Controls*, Wall St. J., Aug. 7, 2014.

²¹ See Comfort, *Deutsche Bank’s Legal Troubles*, *supra*.

²² See Stephen Morris & Olaf Storbeck, *Deutsche Bank to Set Up €50bn ‘Bad Bank’ as Part of Overhaul*, Fin. Times, June 16, 2019.

²³ See Matt Scuffham, *Exclusive: Deutsche Bank Braced for Continued Fed Restrictions on U.S. Business – Sources*, Reuters, June 20, 2019.

²⁴ See Robert Armstrong & Kiran Stacey, *Deutsche Faces U.S. Money-Laundering Probe*, Fin. Times, June 19, 2019.

- Subject to the Independent Foreclosure Review (IFR) by the now defunct Office of Thrift Supervision under its old name, Sovereign Bank,²⁵ and in 2015, was found noncompliant with the IFR's terms and had restrictions placed on its mortgage servicing;²⁶
- Subject to a Board enforcement action for declaring a dividend in violation of its approved capital plan;²⁷
- Subject to an OCC enforcement action for deceptively marketing identity theft products;²⁸
- Subject to a Board enforcement action for deficiencies in governance, risk management, capital planning, and liquidity risk management;²⁹
- Charged by the Department of Justice with violations of the Servicemembers Civil Relief Act by repossessing automobiles;³⁰
- Charged by the CFPB with fair lending violations related to its automobile lending program;³¹ and
- The first bank to fail the Board's CCAR stress test 3 consecutive years.³²

Quite simply, if these banks are not able to handle day-to-day management and operations, they should not have their prudential standards relaxed. These standards, if designed properly, are intended to provide a financial backstop to such qualitative weaknesses.

IV. The Proposed Rule is Being Made with Incomplete Information.

U.S. regulators have generally had a less comprehensive picture of the activities of foreign banks than domestic ones. In this case, it is problematic that the Board does not have the full range of cross-jurisdictional activity data that serves as the basis for the proposed categories.³³ According

²⁵ See *In the Matter of Sovereign Bank*, Order No.: NE-11-17 (Apr. 13, 2011), available at:

<http://www.occ.gov/static/ots/misc-docs/consent-orders-97662.pdf>.

²⁶ See *In the Matter of Santander Bank, N.A.*, OTS NE- #2015-065 (June 16, 2015), available at:

<http://www.occ.gov/static/enforcement-actions/ea2015-065.pdf>.

²⁷ See Written Agreement between Santander Holdings USA, Inc. & Federal Reserve Bank Of Boston, Docket No. 14-028-WA/RB-HC (Sept. 15, 2014), available at:

<http://www.federalreserve.gov/newsevents/press/enforcement/enf20140918a1.pdf>.

²⁸ See *In the Matter of Santander Bank, National Association*, AA-EC-2015-04 (Mar. 26, 2015) available at:

<http://www.occ.gov/static/enforcement-actions/ea2015-024.pdf>.

²⁹ See Written Agreement between Santander Holdings USA, Inc. & Federal Reserve Bank of Boston, Docket No. 15-018-WA/RB-HC (June 26, 2015), available at:

<http://www.federalreserve.gov/newsevents/press/enforcement/enf20150707a1.pdf>

³⁰ See Press Release, "Justice Department Reaches Settlement with Santander Consumer USA to Resolve Allegations Concerning Over 1,100 Illegal Car Repossessions Against Service Members," U.S. Dept. of Justice, Feb. 25, 2015, available at: <https://www.justice.gov/usao-ndtx/pr/justice-department-reaches-settlement-santander-consumer-usa-resolve-allegations>

³¹ Peter Rudegeair, *Santander Consumer USA Says CFPB Finds Alleged Fair-Lending Law Violations*, Wall St. J., Aug. 10, 2015.

³² See Martin Arnold & Ben McLannahan, *Santander to be Granted Exemption in U.S. Stress Test*, Fin. Times, Jan. 16, 2017.

³³ See Board of Governors for the Federal Reserve System, Presentation Materials for Prudential Standards for Foreign Banking Organizations at 5 (Apr. 8, 2019).

to other sources, five of the foreign banks have a level of cross-jurisdictional activity that exceeds the activity of the two largest U.S. GSIBs.³⁴ Finally, introducing additional uncertainty into the proposal, global banks' use of foreign currency creates complexity and risk, given the difficult task of reconciling calculations using exchange rates that vary at any given point in time.³⁵

It is difficult to understand why the Board would move ahead on this proposal with incomplete information. Regulating the largest global banks has been analogized to cars that are speeding down the road at 100 miles per hour that are spaced 5 feet apart from one another.³⁶ Such a small margin for error is particularly problematic when regulations are crafted with insufficient information to monitor the situation and prevent harm. The obvious solution is to have the cars have a greater buffer between them and follow each other at much greater lengths – in this case more robust standards that are not “tailored” with little margin for error.

V. Conclusion.

Given the arguments made here and elsewhere about scarce regulatory resources, the Board should not prioritize using its resources to deregulate large foreign banks. Instead, a better focus would be improving the regulation of FBOs.³⁷ Here are two examples of changes that would be beneficial and worth your efforts.

First, whereas relaxing the prudential rules for FBOs is misguided, the revisions to FBO reporting are a positive step that I support. To date, the Board does not compile systemic risk data for the branch networks of FBOs.³⁸ The aspect of the proposal that would incorporate all FBOs' U.S. operations into the FR Y-15 reporting form would provide a more comprehensive picture of an FBO's financial profile and is long overdue.

In her statement on the proposed FBO rule, Governor Brainard noted that the Board has failed to apply more prudential standards to U.S. branches and agencies of foreign banks.³⁹ I agree. In particular, the Board should apply additional prudential standards, including capital

³⁴ See Glasserman & Loudis, *supra*, at 6, Figure 7.

³⁵ See *id.*, at 8.

³⁶ See “Debt Financing in the Domestic Financial Sector,” Subcommittee on Financial Institutions and Consumer Protection, Committee on Banking, Housing, and Urban Affairs, United States Senate, S. Hrg. 112–270 at 25 (2011) (statement of Paul Pfleiderer, C.O.G. Miller Distinguished Professor of Finance, Graduate School of Business, Stanford University).

³⁷ Wall Street banks, their lobbyists, and trade associations often argue for deregulation by saying that better rules will put U.S. banks at a disadvantage to their foreign competitors. While the evidence clearly shows that this claim is false, it is difficult to see any competitive or other benefits to U.S. banks in deregulating their foreign competitors.

³⁸ See, e.g., Ofc. of Fin. Research, Size Alone is Not Sufficient to Identify Systemically Important Banks 9, Office of Financial Research Viewpoint 17-04 (2017) available at: https://www.financialresearch.gov/viewpoint-papers/files/OFRvp_17-04_Systemically-Important-Banks.pdf

³⁹ See Governor Lael Brainard, Statement on Proposals to Modify Enhanced Prudential Standards for Foreign Banks and to Modify Resolution Plan Requirements for Domestic and Foreign Banks, Apr. 08, 2019, available at: <https://www.federalreserve.gov/newsevents/pressreleases/3B1F641BEB4A485B994EBC38165F0F3B.htm>.

requirements, to the U.S. branches and agencies of foreign banks, as some European authorities have done.⁴⁰ Increasing reliance on equity capital is preferable to the proposed rule's emphasis on liquidity because, as mentioned above, many foreign banks were badly undercapitalized during and after the crisis. Equity funding reduces vulnerability to runs, does not lead to deleveraging through asset sales, and does not lead to micromanagement of the asset side of the balance sheet.⁴¹

For the foregoing reasons, I urge the Board not to move forward with its FBO proposal, and instead to improve and strengthen regulations to mitigate the risks that large FBOs pose to the financial system. Thank you for considering my views on this important matter.

Sincerely,

A handwritten signature in black ink, appearing to read "Graham Steele". The signature is fluid and cursive, with the first name "Graham" and last name "Steele" clearly distinguishable.

Graham S. Steele (steele63@stanford.edu)

Staff Director

Corporations and Society Initiative

Stanford Graduate School of Business

⁴⁰ See OFR, *Size Alone is Not Sufficient to Identify Systemically Important Banks*, *supra*, at 9-10.

⁴¹ See Anat Admati & Martin Hellwig, "Bank Leverage, Welfare, and Regulation," at 13-15 (Jan. 2019), available at <https://admati.people.stanford.edu/sites/g/files/sbiybj1846/f/publications/admati-hellwig-cigi-chapter-jan-2019.pdf>